

State Investment Commission
Minutes
March 8, 2004

The State Investment Commission ("the Commission") was called to order by George R. Burgess, Jr., proxy for Acting Chairman Robbie Rudolph, Secretary, Finance and Administration Cabinet at 2:30 p.m. on March 8, 2004 in Room 264 of the Capitol Annex. Other members present were Jim King, King and Company PSC; Mike Alexander, proxy for Governor Ernie Fletcher; and Brooke Parker, proxy for Jonathan Miller, State Treasurer. Treasurer Miller participated by phone.

Mr. Burgess confirmed that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. Alexander and seconded by Mr. King to approve the minutes of the December 18, 2003 minutes. Motion **CARRIED**.

Mr. Dwight Price, Portfolio Manager, Office of Financial Management, presented a portfolio update to the Commission members. Mr. Price indicated that the information in Attachment A compares the Commonwealth's portfolio against the Index. Mr. Price indicated that the portfolio does not balance exactly to the Index. Mr. Price stated, however, that the bond proceeds pool and the intermediate pool are performing closely to the Index. Mr. Price indicated that both pools have outperformed the Index on a 12-month rolling average and a 3-year rolling average. Mr. Price indicated that he did not expect the portfolio to become AIMR (Association for Investment Management and Research) compliant, but that every effort would be made to become as close as possible. He also indicated that the portfolio performance might be extended to a 5-year rolling average once data is available.

Mr. King asked if it was possible to predict when interest rates would begin to trend upward. Mr. Steve Jones, portfolio administrator, Office of Financial Management, stated that since the drop in monthly unemployment several days ago, interest rates decline until approximately 80 percent of mortgages became refinancable. Mr. King asked why the rates are trending downward. Mr. Jones stated in February that the economy created 21,000 new jobs, which was below market expectation. Mr. King asked if the published claims for unemployment are compared to the previous week or the same week in the previous year. Mr. Jones indicated that the data is for the previous week. Mr. Jones also stated that a 4-week rolling average is released at the same time and is a good indicator of the unemployment trend. Mr. Price indicated that jobs are presently moving the market.

Mr. Jones further indicated that the FED would not raise interest rates until more jobs are created. Mr. Price pointed out that President Bush could be the first sitting President since Herbert Hoover who experienced job loss during his administration.

Mr. Jones discussed the Commonwealth's interest rate swaps. Mr. Jones stated that in July 2003, funds were moved from the intermediate term pool to the short-term pool in order to consolidate all General Fund monies in the short-term pool. Mr. Jones said that staff felt it would not be beneficial to the Commonwealth at that time to sell assets to generate the cash needed to move funds between the two pools. As a result, two interest rate swaps were

purchased to synthetically offset the sale. Mr. Jones indicated that the two swaps were sold on February 12, 2004, for a gain of \$640,000. If the securities, which were sold in July 2003, had been held until February 12, and sold at that point, the Commonwealth would have received roughly \$753,000 less for the sale. Mr. Jones explained that by using interest rate swaps to offset the July sale, the Commonwealth benefited by \$1,393,000 which is the sum of the avoided loss and the actual cash gain.

Mr. Price indicated that transactions of this nature would add additional value to the portfolio and make it possible for the portfolio to compete against the Index. Mr. Price indicated that Ted Munday, the programmer for the investment section, would be tracking trends of spreads widening and narrowing to allow for more active trading.

Treasurer Miller asked how the net loss of \$753,071.75 and the gain of \$640,000 were added together. Mr. Jones stated that if the Agency securities had been held in July and sold on February 12, 2004 the loss would have been \$753,071.75. Mr. Jones indicated that \$640,000 represents actual cash in the bank.

Mr. Burgess introduced Resolution SIC 2004-1 which authorizes the Commission to invest in certain securities.

Mr. Price indicated that several months ago the portfolio owned a security that was downgraded. Mr. Price further stated that 200 KAR 14:011 is specific about the rating a security must have before staff can purchase it, but is not specific about the action that needs to be taken if a security falls below A. Mr. Price indicated that Resolution SIC 2004-01 allows staff 90 days to liquidate the position. Mr. Price pointed out that when the rating on a security falls, individuals who own the security may sell immediately, which causes the spread to widen dramatically and would result in a substantial loss to the Commonwealth. Mr. Price further stated that if the staff had some flexibility in selling the security, it would allow staff to wait until the spread tightens before selling the security and minimize the loss to the Commonwealth.

Treasurer Miller asked why staff would hold on to the security if the rating drops? Mr. Price indicated that the administrative regulations are clear on the purchase of securities but not on when to hold the securities in the portfolio. Treasurer Miller asked if the Commonwealth's portfolio was subject to any undue risk by holding on to a security that drops to BBB? Mr. Price indicated that BBB rated securities are investment grade securities and are considered safe for any type entity.

Treasurer Miller expressed concern that the legislature's intent was any security with a credit rating of less than A should be sold. Treasurer Miller felt that the Commission should have a strong argument for not selling the security immediately after the credit rating drops. Mr. Steve Jones stated that the argument he would make against selling a BBB security is that according to Moody's Investors Service, Ford is rated BBB. Mr. Jones continued that Ford is a strong company and is the type of security that the Commonwealth should hold.

Mr. Price reiterated that the maximum period the security would be held is 90 days. Mr. Price continued that staff would be able to sell immediately, if necessary, but 90 days would provide an opportunity to minimize the loss.

Treasurer Miller stated that he was in total agreement, but wanted to make sure of the intent of the legislature. Mr. Price indicated that staff drafted the legislation and the legislature passed the legislation as drafted.

Mr. Tom Howard, Deputy Executive Director, Office of Financial Management, stated that he was called to testify when the original bill was drafted. Mr. Howard felt that the idea of setting a minimum threshold purchase was to allow the Commission some latitude in holding and selling securities. Mr. Howard stated that although the statutes were not crafted to address this specific issue, he felt that the Commission should adopt Resolution SIC 2004-01 to allow staff the latitude needed when the credit rating on a security held by the Commonwealth drops.

Treasurer Miller indicated that he would support this Resolution based on the recommendation of staff that the intent of the legislation was not to prevent the Commission from holding on to BBB-rated securities or that the Commission was lowering the standards of the securities held by the Commonwealth.

Mr. Jim King stated that he had some concern about approving the Resolution as written. Mr. King indicated that the Resolution states that any security whose credit rating drops below BBB will be sold within 90 days of the rating change instead of stating that the security would be sold if it drops below A to BBB. Mr. King asked if the intent was to allow staff 90 days to sell the security once it drops below A. Mr. Jones indicated that the original intent was to allow the security to be held at the discretion of staff if it drops to BBB. Mr. Jones continued that if any of the three rating agencies rated the security below BBB, then staff would have 90 days to sell the security.

Mr. King stated that he felt the Commission should only invest in those securities indicated as stated in the statutes and should hold a security only long enough to dispose of the security in a reasonably orderly fashion. Mr. King stated that a BBB-rated security is below what the legislature allows the Commission to purchase and that the policy of the Commission should be that the Commission has 90 days to dispose of any security that drops to BBB.

Treasurer Miller indicated that he would be more comfortable with that policy. Treasurer Miller asked which legislators were involved in drafting the legislation? Mr. Howard indicated that a presentation was made to the Banking and Insurance and the State Government Committee. Mr. Price indicated that this part of the legislation was included in House Bill 5 of the 1997 Session of the General Assembly.

Mr. Burgess indicated that Mr. Price and Mr. Jones would revise the Resolution and forward to the Commission members before the next meeting.

Mr. Price discussed Attachment D, Securities Lending. Mr. Price informed the Commission that ASTEC Consulting Group who is a leading consultant in securities lending produced the graphs in Attachment D. Mr. Price pointed out that the graphs indicated that the Commonwealth's performance has been excellent. Mr. Price stated that there are several reasons why the Commonwealth's portfolio has performed so well. Mr. Price indicated that the securities lending program is very well structured and dictates what securities the lending agent is allowed to invest in. Mr. Price also stated that Credit Suisse First Boston has a very qualified, dedicated staff that works very hard to bring added value to the Commonwealth's portfolio. Mr. Price indicated the third reason that the securities lending program has performed well is because the make-up of the Commonwealth's portfolio lends itself to low loan rates.

With no further business before the Commission, a motion was made by Mr. Alexander and seconded by Mr. King to adjourn the meeting.

Respectfully submitted,

George R. Burgess, Jr.
Executive Director